UNITED STATES DEPARTMENT OF AGRICULTURE
FARM CREDIT ADMINISTRATION
WASHINGTON, D. C.

QUARTERLY SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

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Prepared for the

COOPERATIVE RESEARCH AND SERVICE DIVISION

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TREASURY DEPARTMENT MEMORANDUM ON CURRENT TAX TREATMENT OF PATRONAGE REFUNDS

During the course of the Hearings before the Committee on Ways and Means, House of Representatives, on Revenue Revision of 1951, Mr. Lynch, General Counsel of the Treasury Department, was requested to furnish a memorandum as to the Treasury's position with respect to the exclusion of patronage refunds from taxable income under the present law. The memorandum, which appears on pp. 2858-2859 of Part 3 of the printed hearings, reads as follows:

"A taxable cooperative is a cooperative other than a farm cooperative specifically exempt from income tax under section 101 (12) of the Internal Revenue Code. It is subject to the corporate tax. However if a cooperative has agreed at the time of any sale to or purchase from its patrons to allocate or return to them any net proceeds of the current year in proportion to patronage, it can compute its tax only on the amount of its net proceeds which have not been so allocated or returned as 'patronage dividends.' It should be noted that, if only members of the cooperative may receive patronage dividends, the cooperative may not omit from gross income the portion of any distributions to members which represents profits from dealings with nonmembers.

"This treatment of patronage dividends has been a long-established practice of the Bureau of Internal Revenue. Such treatment, at the time of its adoption, was based on the theory that amounts allocated or returned as patronage dividends represented a reduction in cost to the patron of goods purchased by him through the cooperative or an additional consideration due the patron for goods sold by him through the cooperative.

"One of the earliest Bureau rulings on the matter was under the Revenue Act of 1913. That act exempted from the income tax mutual savings banks not having any capital stock represented by shares. However, it prescribed a rather different treatment for mutual fire insurance companies whose members made premium deposits to provide for losses and expenses. These insurance companies were not required to include in taxable income any portion of the premiums returned to their policyholders as so-called policy dividends. Income from other sources and premium payments retained by these companies for purposes other than the payment of losses and expenses and reinsurance reserves were, however, taxable. The Treasury by analogy

adopted in 1914 a similar rule for farm cooperative associations which were not eligible for exemption under the 1913 act and permitted them to exclude patronage dividends from gross income. (See T. D. 1996.) The Regulations under the 1916 act, like those under the 1913 act, provided that any cooperative association which could not qualify for the statutory exemption of farm cooperatives because it did not, as then required by the statute, act strictly as agent but purchased produce from members with a view toward selling it for gain, might nevertheless exclude from gross income all amounts paid to members on the basis of quantity of goods handled for them.

"Treasury rulings consistent with the above have been issued during that period until the present time. Examples are T. D. 2737 (1918), IT 1499 (1922), IT 1566 (1923), GCM 12393 (1933), GCM 17895 (1937). The present tax treatment of patronage dividends thus represents a long-established administrative practice.

"This practice has been recognized by the Courts as valid. Examples of recent decisions are Associated Grocers of Alabama v. Willingham, 77 F. Supp. 990; Peoples Gin Company v. Comm'r, 118 F. (2d) 72; and Fountain City Co-op Creamery Association v. Comm'r, 172 F. (2d) 666. In an opinion which exhaustively reviews the administrative and judicial precedents in the matter, the District Court for the Northern District of Iowa concluded: 'This practice * * * has been recognized and apprived by the courts'. (86 F. Supp. 201, 238). That court also specifically held:

"'1. That the Treasury Department rulings providing that under certain conditions a cooperative may exclude from its gross income for federal income tax purposes amounts allocated as patronage dividends are not so unreasonable or so plainly inconsistent with the Internal Revenue Code as not to be followed' (p. 237).

"Moreover, it does not seem unimportant that during this long period of uninterrupted administrative practice, the Congress has not changed the rule by legislation, even though during a period of over 30 years it has often reenacted various revenue acts. It has been indicated by the Supreme Court that where there has been a contemporaneous administrative construction of a congressional enactment followed by long-continued administrative practice, reenactment 'amounts to an implied legislative recognition and approval of the executive construction of the statute' (National Lead Co. v. U.S., 252 U.S. 140)."

(R. J. Mischler)

PROPRIETARY MILK HANDLERS HAVE NO JUSTICIABLE INTEREST IN THE LOCATION DIFFERENTIAL TO PRODUCERS AND COOPERATIVE ASSOCIATIONS HAVE NO STANDING TO CHALLENGE THE SECRETARY'S ORDER IN THIS MATTER

The Judicial Officer of the Department of Agriculture, on March 29, 1951, issued a decision on the petition of Sanna Dairies, Inc., and three cooperative associations, challenging the validity of the producer location differentials under the Chicago milk order. The petitions were filed under Section 8c(15) (A) of the Agricultural Marketing Agreement Act. The decision of the Judicial Officer is noteworthy in that he held that the proprietary handlers had no justiciable interest in the location differential to producers becasue these differentials do not affect the net cost of milk to the handler. The Judicial Officer further concluded that, since only handlers can be petitioning parties under Section 8c(15) (A) of the Act, since the cooperative associations have no standing as handlers to challenge these provisions of the order, and since cooperative associations are not eligible as producers to prosecute Section 8c(15) (A) petitions, the cooperative associations likewise had no standing to challenge the protested provisions of the order in a Section 8c(15) (A) proceeding. (The right of the cooperative associations to challenge the validity of the protested provisions was not questioned in the proceeding.) The Judicial Officer decided, however, that, in any event, he was of the opinion that the provisions complained of were within the scope of the notice of the promugation hearing and fully supported by the evidence in the record of that hearing.

(R. D. Burchard)

UNITED STATES SUPREME COUNT GRANTS CERTIORARI TO REVIEW DECISION HOLDING SECRETARY OF AGRICULTURE EXCEEDED HIS STATUTORY POWERS IN MAKING ORDER REGULATING MARKETING OF MILK

In Brannan v. Stark, memtioned in Summary No. 49, page 7, the Supreme Court granted certiorari on April 16, 1951. This litigation has been pending since 1941, and the issues relate primarily to whether the provisions in the Boston milk order for payments to cooperative associations of producers for marketwide services are "necessary" and "incidental" to the classification, pricing, and pooling provisions in the milk order, and also whether the payments are "inconsistent" with the statutory requirement for a "uniform price" for milk subject only to the enumerated "adjustments" in § 8c(5) of the Agricultural Marketing Agreement Act of 1937.

(R. D. Burchard)

NONPROFIT MEMBERSHIP CORPORATION HELD NOT TAXABLE ON FUNDS SUBJECT TO RETURN TO SUBSCRIBERS AS REBATES

On May 10, 1951, the Tax Court of the United States rendered a decision (16 T.C. 122) in the case of Broadcast Measurement Bureau, Inc., Petitioner, v. Commissioner of Internal Revenue, Respondent. This case, while it does not deal with a farmers' cooperative, is of special interest to cooperative associations and is of value in connection with the status, for income tax purposed, of refunds to members and patrons.

The petitioner, a nonprofit membership corporation, was organized for the purpose of conducting research and investigations regarding radio broadcasts.

We are primarily concerned with two issues in the case. They are stated as follows:

> "1. Did petitioner realize any income in the fiscal year ended June 30, 1946?
>
> "2. If petitioner realized income in the fiscal year ended June 30, 1946, was it exempt from income and excess profits taxes thereon under sections 101 (7) and 727 (a) of the Code, respectively?"

The findings of fact may be the court are in part as follows:

> "As stated in its certificate of incorporation, the purposes for which petitioner was organized were
>
> "To foster, promote and conduct research and investigations to establish measurements of broadcasting of all types; to develop standards for the measurement and evaluation of broadcasting audiences of all types; to establish and supervise practices in connection with the collection, tabulation, evaluation and authentication of audience data with respect to the entire broadcasting industry; to prepare and issue statements and reports of audience date of the broadcasting industry and to perform other acts and services which will further the mutual interests of advertisers, advertising agencies and the broadcasting industry in the accurate and scientific evaluation of the broadcast advertising medium.

* * * *

"The chief reason for the organization of petitioner was to meet a crying need for a uniform reliable standard of radio audience measurement for individual stations and networks. Radio broadcasting grew at a rapid pace over a period of 25 years so that by 1945 the Government had licensed about 900 stations. From the very first a need was felt in the broadcasting industry for some sort of acceptable measurement whereby it could be determined how many people were listening to the radio signal of a given station. Competition between radio stations for advertising business became very keen. Stations and networks in the same area laid claim to the largest audience in the area, so that conflicting claims resulted. Different measurement techniques were used by various stations or by concerns which they hired. Due to inadequate preparation and poor formulae, the results were unreliable in many instances. The effect of this chaotic condition on advertisers was that they came to believe none of the conflicting claims of the stations. A good many advertisers refused to send programs into certain areas where the claims were in greatest conflict. This condition was harmful to the broadcasting industry which was in competition with such other advertising media as newspapers and billboards, which had authenticated means of proving their circulation.

* * * *

"The subscription contracts used by BMB and each of the subscribing stations up until July 1, 1947, provided for payment of a fixed amount as a subscription fee for the performance of Study No. 1. The amount of the fee paid by each station was based on its net receipts in 1944. The contract also stated:

> "In consideration of Broadcast Measurement Bureau, Inc. undertaking a nationwide station audience study, Radio Station . . . . . agrees to abide by the rules and regulations promulgated by Broadcast Measurement Bureau, Inc, and to pay to it, in accordance with the method indicated on the reverse side hereof, the sum of . . . . . as and for the subscription fee of Station . . . . . for the first study.
>
> "It is mutually understood and agreed that the amount of this subscription fee may be adjusted by Broadcast Measurement Bureau, Inc., upon the completion of the first study, on the basis of station audience, ballot

mentions, net sales, or a combination of other like factors disclosed by said study. Should such adjustment result in an increase in the amount of this subscription fee, such increase shall not exceed 25 per cent.

"Essentially the same clauses were contained in subscription contracts between BMB and networks subscribing for the performance of Study No. 1.

"With regard to the funds raised by these subscriptions BMB stated its position in a series of questions and ansers in the January 1946 issue of 'To Date' as follows:

"Question: What happens if you don't spend all the money raised by subscriptions?

"Answer: BMB is a non-profit organization. All surpluses will be reapportioned to subscribers or can be left as credits to the subscribers toward the next study.

"In another section of the same issue of 'To Date' petitioner also stated:

" * * * The Bureau has declared that at the completion of the first study made, it will adjust the amount of this subscription in accordance with station net audience, ballot mentions, net sales, or a combination of other pertinent factors. * * *

"It was the understanding of both BMB and subscribers that the words 'may be adjusted' in the contract meant there would be an adjustment either upward or downward at the conclusion of stud No. 1; that is, if the stations were charged more than the costs of the study came to, the entire excess would be returned by BMB, based on a formula which it would determine; there was no ceiling placed on such refund; if, however, the costs of Study No. 1 were more than the subscription fees, BMB had the right to make an added assessment on subscribers which was not to exceed 25 percent of the original subscription fee. The termination date for Study No. 1 was left within the discretion of BMB as were the date for making refunds or credits and the determination of subscribers eligible for a refund or credit.

"Beginning July 1, 1947, BMB entered into a different type of station and network subscription contracts. The new contracts did not call for the payment of a fixed fee for the performance of a single study, but rather provided for monthly payments of a fixed amount by subscribers for an indefinite period, during which the subscriber would be entitled to all the services and reports made by petitioner. The subscriber was permitted to cancel its subscription contract at any time after the contract had been in effect one year, provided it gave ninety days' notice.

"The new subscription contract for stations stated in part:

"8. At the time of each Final Industry Accounting the Bureau will examine all of its receipts and expenditures since the preceding Final Industry Accounting. If the Board finds that there is an excess of receipts such declared excess shall be returned to the subscribers, as a refund or credit as determined by the Board, on the basis of the subscriber's pro rata share of the total national survey and operating costs. The formula which will be used to determine a subscriber's pro rata share of said costs shall be applied uniformly to all station subscribers.

"The new subscription contract for networks read in part:

"8. The Bureau agrees that at the time of any final Industry accounting the total subscription fees paid in by the Subscriber since the preceding final Industry accounting may be adjusted downward by the Bureau as a rebate or credit on the basis of the Subscriber's pro rata share of the total national survey and operating costs. The formula which will be used by the Bureau in order to determine a Subscribers's pro rata share of said costs shall be applied uniformly to all regional network subscribers.

"During the fiscal years listed below, petitioner, which kept its books on the accrual basis, had the following receipts and disbursements:

	Fiscal Year ending 6/30/45	Fiscal Year ending 6/30/46	Fiscal Year ending 6/30/47
Subscriptions collected	$72,425.00	$1,004,809.90	$223,735.10
Sales of Reports	—	—	21,331.95
Disbursements	32,678.50	678,972.00	511,281.24
Balance	39,746.48	—	(266,214.19)*
Unexpended balance as of close of fiscal year	39,746.48	365,584.38	99,370.19

*Net operating loss

"A financial accounting, in summary form, of the foregoing was issued to subscribers by the finance committee in September 1947. This summary made no mention of refunds or credits, nor did it disclose any liability for refunds due subscribers. Petitioner never physically segregated the fees collected for Study No. 1, though the total amount thereof and the unexpended balance were recorded on its books at all times.

"Petitioner's board of directors set June 30, 1947, as the close of Study No. 1. The $99,370.19 balance of subscription fees over Study No. 1 costs resulted from the fact that in drafting its contracts for Study No. 1, BMB was faced with two uncertainties, what the study was going to cost and how many stations would subscribe. On December 2, 1947, BMB's executive committee adopted the following resolution:

> "WHEREAS, the audit of the Bureau's accounts for its fiscal year ended June 30, 1947, discloses an excess of receipts over expenditures, from the date of organization to the close of such period, totaling $99,370.19, including cash and other assets remaining from subscriptions and other receipts in connection with Study No. 1; and
>
> "WHEREAS, under its subscription contracts, Broadcast Measurement Bureau, Inc., is liable to adjust the subscription fees by formula at the conclusion of Study No. 1, and such adjustment will involve refunds of over-payments by certain subscribers.
>
> "NOW, THEREFORE, BE IT
>
> "RESOLVED, that the amount of such liability to subscribers be entered as a liability upon the Bureau's books of account, and be it further

"RESOLVED, that effective immediately upon the conclusion of the final Industry Accounting for Study No. 1, and upon the determination of the Federal income tax liabilities of the Bureau, if any, the excess of receipts over expenditures remaining at such date be repaid by formula to subscribers of record as of June 30, 1947.

"Upon the adoption of these resolutions an entry was made in petitioner's books of account showing a liability of $99,370.19 to subscribers to Study No. 1. Such amount was also entered as a liability in the balance sheets attached to the income tax returns filed by BMB in 1947. No previous accrual of a liability to subscribers for Study No. 1 had been made on BNB's books. Neither a date for making refunds or credits, nor the amounts thereof have been fixed by BMB, because its executive committee considered that if there were any tax liabilities arising out of the performance of Study No. 1, they would constitute an expense of such study which should be deducted in computing the amounts returnable to subscribers to Study No. 1.

"Pending the determination of petitioner's income tax liability arising out of Study No. 1, BMB proposed to release the idle money totaling $99,370.19 in the fund for subscribers to Study No. 1 and make it available for use in Study No. 2, provided that a way be found to assure its restoration to the fund once the tax liability of petitioner was determined. To preserve this fund of $99,370.17 petitioner's subscribers were asked to waive their right to cancel theri subscription contracts for future studies. Over 300 subscribers did so. As a further incentive for the release of the money in this fund for use in Study No. 2 pending determination of the tax question, NAB guaranteed payment of any tax liability falling on BMB. The $99,370.19 was then released for Study No. 2, which started early in 1949.

* * * *

"In his notice of deficiency respondent determined that petitioner was not a tax-exempt corporation under sections 101 (7) and 727 (a). Respondent further determined that petitioner had taxable net income in the amount of $99,370.19 in the fiscal year ended June 30, 1946. This figure was computed by subtracting from gross receipts of $1,004,809.90 in that year both disbursements of $678,972 for Study No. 1

and a net operating loss deduction of $226,467.71, which constituted a carry-back of the unused portion of a net operating loss of $266,214,19 incurred by petitioner in the fiscal year ended June 30, 1947. In addition to determining deficiencies in petitioner's income tax, declared value excess-profits tax, and excess profits tax for the fiscal year ended June 30, 1946, respondent determined a five per cent delinquency penalty due to petitioner's failure to timely file the excess profits tax return for that year."

The opinion and concurring opinions follow:

"OPINION

"HILL, Judge; The first question for our determination is whether petitioner realized any income in the fiscal year ended June 30, 1946. It is respondent's contention that BMB realized net income in the amount of $99,370.19 in that year. This figure constitutes petitioner's gross receipts, which came totally from subscription fees in these 12 months, less both its disbursements in that year for Study No. 1 and a net operating loss carried back from the fiscal year ended June 30, 1947. Petitioner arguesthat it had no gross income in the year under consideration on the ground that it received the subscription fees for the specific purpose of performing Study No. 1, and pursuant to a contract with subscribing stations and networks whereby it was obligated to refund any unexpended portion of those fees following the close of Study No. 1. In petitioner's view by virtue of the subscription contracts it did not receive the subscription fees under a claim of right and furthermore it had a definite, unconditional obligation to repay or return the unexpended balance of the subscription fees. Respondent challenges petitioner's contentions for three principal reasons. First, he declares that BMB was not obligated under its contract with subscribers to refund the excess of subscription fees over expenses of Study No. 1. Secondly, assuming such a contractual liability, he asserts that the fees paid in the fiscal year ended June 30, 1946, ere received under a claim of right and there was no difinite, unconditional obligation to refund any part of them as of the close of the fiscal year in issue so that under the doctrine of both Commissioner v. Wilcox, 327 U.S. 404, and North American Oil Consolidated v. Burnet, 286 U.S. 417, these subscription fees constituted gross income, Finally respondent

states that petitioner is not entitled to deduct the excess of subscription fees over disbursements existing at the close of the fiscal year ended June 30, 1946, since there was no liability to refund it at that time, and we may not look beyond events occurring in that year, citing Burnet v. Sanford & Brooks Co., 282 U.S. 359, and Security Flour Mills Co. v. Commissioner, 321 U.S. 281.

"We are convinced that the subscription fees to Study No. 1 which petitioner received in the fiscal year ended June 30, 1946, were impressed with a trust upon their receipt to expend them solely to meet the costs of Study No. 1 so that they constituted a trust fund in its hands rather than income. Whether a trust existed with regard to the subscription fees received by BMB in the fiscal year ended June 30, 1946, depends upon the intent of the parties. No express words of trust were used, but none are necessary. Hibbard, Spencer, Bartlett & Co., 5 B.T.A. 464. Close analysis of the subscription contracts entered into between petitioner and subscribing stations and networks, the understanding of the parties with regard to these contracts, and the performance of petitioner in execution of these contracts persuades us that the parties intended that BMB receive the subscription fees in trust for the subscribers to carry out Study No. 1. We find a reasonable certainty as to the property, the objects and the beneficiaries, and in such a situation no particular forn of words is necessary to create a trust. Chicago, Milwaukee & St. Paul Railway Co. et al, v. Des Moines Union Railway Co., et al, 254 U.S. 196.

"The subscription contracts entered into between BMB and subscribing stations and networks for Study No. 1 expressly provide for subscription fees of a fixed amount for the performance of a single study. Use of these fees for any other corporate purposes including any future studies would be in direct violation of the contract terms. Thus petitioner was narrowly restricted in the use of the subscription fees.

"Furthermore, we interpret the aforesaid subscription contracts to provide that petitioner was obligated to return to subscribers either as a refund or as a credit on future studies, any excess of fees over the actual costs of Study No. 1 after the conclusion of such study. These subscription contracts expressly state in part:

"It is mutually understood and agreed that the amount of this subscription fee may be adjusted by Broadcast Measurement Bureau, Inc. upon the completion of the first study. * * *

"Respondent contends that a refund or credit was not contemplated by the parties to the contract when they used the word 'adjusted' and even assuming that such was their intent, the words 'may be' are permissive in nature and therefore a refund of unexpended fees was not mandatory but within petitioner's discretion. This conclusion is borne out, he says, by the new station subscription contract form used after July 1, 1947, which provides that any excess 'shall be returned to the subscribers as a refund or credit.' He contends that the use of the work 'refund' and the mandatory language in this later contract constituted a change in the obligations assumed by petitioner brought on by the fact that a revenue agent was examining petitioner's books at the time.

"There can be little doubt that the first subscription contract used by BMB and its subscribers was not drafted in clear language, so that the phrase 'may be adjusted' is capable of several interpretations, including that suggested by respondent. In determining the true meaning of the phrase, we find little help from an examination of the contracts used by BMB and its subscribers after June 30, 1947. We note that the language of clause 8 of such subscription contracts with stations and the language of clause 8 of such subscription contracts with networks, while dealing with the same subject matter, contrast sharply in their treatment of a refund or credit following each final industry accounting. It is true the language in the subscription contracts with stations has the effect of making a refund or credit mandatory. But clause 8 of the subscription contract with networks, states in part:

"The Bureau agrees that at the time of any final Industry accounting the total subscription fees paid in by the Subscriber since the preceding final Industry accounting may be adjusted downward by the Bureau as a rebate or credit * * *.

"This language on its face is clearly permissive in nature and would not impose a definite obligation on petitioner to return unexpended subscription fees in the form of a refund or credit. Nevertheless we can find no evidence which would lead us to believe that BMB intended a differect treatment of excess subscription fees as between stations and networks. Therefore we hesitate to draw any conclusion from a reference to the later contracts.

"We prefer to determine the true meaning of the phrase 'may be adjusted,' as used in the contracts prior to July 1, 1947, from the testimony of representatives of the contracting parties, and from written evidence introduced at the hearing which was contemporaneous with the signing of these contracts. The testimony of witnesses representing both subscribers and BMB is unanimous that it was their understanding that BMB was obligated by the contract to return either as a refund or as a credit on future research studies, any unexpended fees following the close of Study No. 1. Furthermore, in its publication 'To Date,' distributed to stations and networks in 1946, BMB made statements set forth in our findings, whose clear import is that BMB considered itself bound to return to subscribers as a refund or credit any excess of fees over expenses after the close of Study No. 1.

"Moreover, this interpretation of the contract phrase seems entirely reasonable to us. There is a plausible explanation for the use of the words 'may be adjusted' other than that BMB had a discretion whether to return unexpended receipts. The fees charged were calculated to cover the costs of Study No. 1, yet due to the uncertainty regarding both the total costs and the total number of stations and networks which would subscribe, it was possible that the fees would either exceed or be less than the costs. In such a case an adjustment would be necessary, but this necessity was not certain. Turning to the word 'adjusted,' clearly it is susceptible of meaning either an upward or downward revision of the fees paid in. That a refund or credit was contemplated as a possibility by the parties as well as an additional levy on subscribing stations is borne out by a succeeding phrase which states 'Should such adjustment result in an encrease in the amount of this subscription fee * * * .' Furthermore it is difficult to believe subscribers would be willing to enter into a contract whereby BMB had the right to ask additional payments up to 25 per cent of the original fees to meet Study No. 1 expenses, and also had a discretion whether to return any unexpended fees. The fact that so many subscribers voluntarily entered into such a contract is a strong indication of a mutual understanding that a refund or credit was just as much an obligation of petitioner, if expenses were less than fees paid in, as it was a right of petitioner to make a further assessment from its subscribers, if subscription fees failed to meet the cost of Study No. 1. We therefore conclude that under these contracts it was mandatory that BMB

return to subscribers the entire amount of any excess of subscription fees over the costs of Study No. 1. The fact that petitioner retained the right to determine the date for the conclusion of Study No. 1 and the date of returning any unexpended fees as well as the right to determine which subscribers would be eligible for a refund or cerdit in no way detracts from that obligation.

"It is thus clear that these dubscription contracts were not contracts for the performance of services by BMB at a profit. BMB could only expend the subscription fees to the extent necessary to meet the costs of Study No. 1. Furthermore the mechanical services necessary for performance of Study No. 1 were farmed out by petitioner. It was the understanding of the members of BMB and subscribers alike that the latter would bear the expenses of this study, but nowhere is there any evidence that petitioner was to receive any compensation for the performance of Study No. 1. In this connection we note the provision in BMB's charter that it is a non-profit concern and that there shall be no capital stock. No capital stock has ever been issued. Moreover by the very nature of its contractual undertaking it was settled from the outset that petitioner would receive no gain regardless of the fact that it would not be known until the close of Study No. 1 whether subscribers would receive a refund or credit or whether they would be askedto pay over additional sums to meet the costs of Study No. 1. Thus in no sense was petitioner selling services to subscribers. It performed services as the agency of the subscribers at the latter's expense confined to the cost to petitioner in such performance. Petitioner got no compensation for its services.

"The terms of the subscription contracts and the understanding of the parties as to their meaning make it clear that BMB was merely a designated fiduciary empowered by subscribers to discharge the specific function of performing Study No. 1 with funds provided entirely by the latter, but any excess fees had to be returned after the conclusion of the study.

"In the performance of its subscription contracts BMB conducted itself as a ficuciary empowered to utilize funds for a specific purpose. It compiled braodcast audience data, prepared and distributed surveys to subscribers,and shortly after the close of Study No. 1 on June 30, 1947, it issued a financial accounting

to subscribers. In December 1947 petitioner recognized its contractual obligation to return to subscribers the entire excess of subscription fees over the costs of Study No. 1 by a resolution of its board of directors and by entries on its books setting forth a liability of $99,370.19 to subscribers to Study No. 1. The fact that no refund or credit has as yet been made does not derogate from petitioner's recognition of its obligation to do so. It has delayed action until its income tax liability could be determined, considering that any taxes found due were a proper item of expense for Study No. 1.

"We find further support for our conclusion that the subscription fees for Study No. 1 constituted a trust fund in the fact that late subscribers to the study were given no financial advantage over those who subscribed at the start. The late subscribers were required to contribute the full amount of their subscription fees.

"A further indication that the subscription fees for Study No. 1 constituted a fund in the nature of a trust fund is found in the fact that subscribers to later studies were not allowed to benefit from the excess of fees contributed for Study No. 1 over the costs thereof. This excess of $99,370.19 was not released for use in Study No. 2, pending determination of petitioner's tax liability, until a sufficient number of subscribers to later studies waived their contract cancellation privileges to insure that receipts would be available to replace and preserve this amount in its entirety for the benefit of subscribers to Study No. 1.

"It may be argued that the subscription fees to Study No. 1 did not constitute a trust _res_ due to the fact these funds were never sebregated in separate bank account from sales receipts received in 1947, loans received by petitioner, and receipts from subscriptions to later studies. But such a commingling of the subscription fees for Study No. 1 with other receipts does not destroy their identity as a trust fund. _Seven-Up Company,_ 14 T.C. 965. Petitioner's books showed the total amount of such fees it received and the unexpended balance thereof at all times. Any improper use of the unexpended balance of these fees by their custodian could have been enjoined by the subscribers to Study No. 1 by a suit in equity. _Portland Creamtion Ass'n. v. Commissioner,_ 31 F. 2d 843.

"In view of all the above circumstance we have found as a fact and now hold that the subscription fees received by BMB for Study No. 1 constituted a fund in the nature of a trust fund in its hands for use by it only to the extent of the cost to it of such study and the promulgation of the results thereof. See Seven-Up Company, supra.

"It is thus clear these subscription fees received in the fiscal year ended June 30, 1946, did not constitute gross income to petitioner. Applying the tests laid down by North American Oil Consolidated v. Burnet, supra, BMB did not receive earnings under a claim of right and without restriction as to their disposition in that year. It did not receive the subscription fees as its own property but rather as burdened with the obligation to use them to meet the costs of Study No. 1 and return any excess. While at the close of the fiscal year ended June 30, 1946, there was no definite, unconditional obligation on BMB to refund any part of the subscription fees, since the study had not closed yet there was always an absolute obligation on petitioner to return any part of the fees not needed to meet the costs of the study. We have previously noted that there was no possibility of gain or profit to petitioner from the receipt of these fees. The Supreme Court in Commissioner v. Wilcox, supra, declared that the possibility of gain or profit was the very essence of taxable income. Therefore we conclude and hold that petitioner realized no gross income and thus no net income in the taxable year ended June 30, 1946.

"We do not consider out holding to conflict with our decision in Clay Sewer Pipe Association, Inc., 1 T.C. 529, affirmed 139 F. 2nd 130, wherein we held the excess of payments made to the taxpayer corporation by its stockholder--subscribers over the corporation's expenses at the close of the taxable year in dispute constituted taxable income. The taxpayer in that case impliedly conceded that the payments thus received were gross income to it except for the portion thereof which exceeded its corporate expenditures. Furthermore such payments received by the taxpayer could be used in its general business so that there was not such a restriction on its use of fees from its stockholders as would constitute them a trust fund. Thus the facts of that case are readily distinguished from those of the present case.

"Our decision in the recent case of Krim-Ko Corporation, 16 T.C.__________, (January 11, 1951) is similarly distinguishable on the facts. Taxpayer there was a profit-making concern. It had not undertaken to return the unexpended sums it received from some of its customers for the purpose of furnishing designated advertising materials and services. Its agreements with customers did not place any restriction on the use of any amounts received by it for advertising, nor indicate in any way it was to act as a trustee.

"In view of our holding on the first question is is unnecesary for us to determine the second question, whether BMB was exempt from Federal income and excess profits taxes under sections 101 (7) and 727 (a) of the Code, respectively, in the fiscal year ended June 30, 1946.

"We pass to the third question for our determination, whether petitioner was liable for a five per cent dilinquency penalty under section 3612 (d) (1) of the Code for failure to timely file its excess profits tax return for the fiscal year ended June 30, 1946. In view of our prior holding that petitioner received no gross income in this period, it follows that petitioner realized no excess profits income that year. By virtue of section 729 (b) (2) of the Code BMB was not required to file an excess profits tax return under these circumstances. We therfore hold that respondent erred in determining a five per cent penalty against petitioner for failure to timely file such a return.

"Reviewed by the Court.

Decision will be entered
for petitioner.

"DISNEY, J., concurs in the result.

"MURDOCK, concurring: The result in this case would be right even assuming that the petitioner was in position to realize income form the gross amounts which it received from subscriptions because such income could be computed only upon a completed contract basis, the contract was not completed in the fiscal year 1946 and, therfore, the excess of receipts over expenditures for the three-year period would not be income for the middle year.

"TURNER, J., concurring: While I agree with the result in this case, I am unable to agree that a trust relationship existed between the petitioner and its members and that the excess of the amounts paid by contributig members, over and above the petitioner's costs of operations, constituted a trust fund. As I read the facts, the operations of the petitioner and the use by it in those operations of the moneys received were not intended to be subject to the restrictions and controls applicable to trusts and trustees, and there is nothing in the actual operations from which any implications to that effect are justified. The injection of trust law not only is needed for the ids-position of this case, but, in future cases, where the result must turn wholly upon the existence or non-existence of trusts, the pronouncements here can only cause trouble and confusion.

"The relationship between the petitioner and its members was simply a contract relationship. There was no net income, and therefore no deficiency in income tax, merely because there was always a valid and binding obligation requiring the petitioner to repay to dues-paying members any and all sums not required in the making of Study No. 1. The situation here, in many respects, is similar to that which existed in Uniform Printing & Supply Co. v. Commissioner, 88 F. 2d 75.

"Due to possible differences in the relationship between the members themselves and between members and the petitioner with respect to the financing of Study No. 2, it is possible a different result might be required. But that is another matter, and is not involved in this case.

"KERN and RAUM, JJ., agree with this concurring opinion."

(R. D. Burchard)

The difference of opinion amoung the judges as to whether this case involved a trust relation is interesting. While in a certain sense cooperatives generally are agents or trustees for their member-patrons, I would not want to see that theory carried so far as to prevent the associations from using refundable monies for normal operating purposed. To do so would hamper and hamstring their operations. It is of particular interest, therefore, to note that three of the judges expressed the view that it was neither necessary nor desirable to invoke the trust theory in deciding this case, preferring to characterize the understanding between the parties as "simply a contract relationship."

It is noteworthy also that the court relied upon the time-honored rule that a cooperative's distributions to patrons must be mandatory if they are to be regarded as of non income character. The court's method of determining the mandatory intent by accepting the testimony of the contractual parties is somewhat of a departure from the record of other similar cases. This seems to support the argument often advanced that a cooperative should be regarded as intending to follow the normal procedures of cooperation even though its legal papers, through inadvertence, may not clearly reflect such intentions.

While the court gave some attention to the fact that the amounts to be refunded had been set up in the accounts as a liability, if seems likely that even greater weight would have been accorded to that action if it had been taken earlier, that is at the close of the fiscal year in question. (This could have been done with a qualification as to possible reduction if any income tax liability ensued.)

It is to be noted that the court took no exception, and in fact paid little apparent attention, to the particular method or "formula" proposed to be used by the petitioner in pro rating the distributed funds among its membership. The subscription agreement, it will be recalled, gave the association (which in essence here probably means the management) the option of choosing various bases. Obviously some of the bases would not parallel the ratio under which the fees had been received.

This is a tendency which will be received with approval by those cooperative leaders who have been endeavoring to formulate the principle that the methods used in cooperative distributions should be matters of internal interest only. On the other hand, in its administrative practice, the Treasury Department (see their Mr. Lynch's memorandum quoted on pages 1 and 2) will not permit a taxable cooperative to exclude from its gross income any distributions made to one group (usually members) of amounts earned on another group (usually nonmembers), with the proration between groups having to be made on the basis of products furnished or funds received. This ruling applies whether or not the cooperative's method of distribution is a mandatory one. The theory followed by the Treasury is that distributions to patrons in ratios that differ from the actual volume of each one's patronage are not in their entirety true cooperative returns or refunds and thus (to the extent that they may differ from a patronage basis) they are regarded as mere distributions of profit on which the association is subject to income tax.

Fundamentally this case is one of the many which need never have been brought to trial if the agreement between the corporation and its members had been more carefully worded so as to make fully clear there was being created a difinite liability for the return of operating proceeds (in this case, excess fees), or for their conversion into shares of capital.

(George J. Waas)

PROCEEDS FROM AGRICULTURAL MARKETING DONE FOR PATRONS HELD NOT INCOME TO COOPERATIVE

Attention is called to a decision of importance to cooperatives in Albany Creamery Association, a cooperative association, Plaintiff, v. United States of America, Defendant, by the United States District Court for the District of Oregon (not reported to date).

The findings of fact and conclusions of law are as follows:

"Findings of Fact

"I. Plaintiff instituted this action to recover corporation income taxes and declared value excess profits taxes collected from it by a former Collector of Internal Revenue of the United States for the District of Oregon for its fiscal year ending November 30, 1942. Jurisdiction of this action is based upon Section 1346 (a) (1) of the Judicial Code of the United States, Title 28.

"II. Plaintiff was originally organized in 1895 as an association under the general corporation laws of the State of Oregon, with a provision in its Articles of Incorporation that it be run upon the cooperative plan. At the time of the organization of plaintiff in the year 1895 and until the year 1915, there was no provision in the laws of the State of Oregon for the formation of agricultural or other cooperative associations.

"III. Plaintiff's original Articles of Incorporation were duly filed with the Secretary of State of the State of Oregon on January 25, 1895, the pertinent article of which is as follows:

"'ARTICLE II. The business of the corporation shall be to locate, establish and erect a creamery plant to purchase or procure milk or cream in any manner it may deem proper; also to manufacture and sell any and all products thereof, and to utilize the refuse product of said creamery for the purpose of fattening hogs or other animals. Also to purchase and hold any personal or real property necessary or convenient for the transaction of its business. That said corporation be run upon the cooperative plan, and that any proceeds arising from the sale of any of its products shall be disposed of as follows:

"'FIRST. To pay for the milk and product of milk bought for the use of said creamery.

"'SECOND. To pay the operating expenses and necessary repairs of the plan of said corporation.

"'THIRD. To pay legal interest to the stockholder of said corporation.

"'FOURTH. The remainder to be paid to the patrons of said corporation who furnish the milk product, in proportion to the value of the product furnished; that no stockholder shall vote more than one share on any question.'

"The foregoing provisions of plaintiff's original Articles of Incorporation were in full effect during its fiscal year ending November 30, 1942.

"IV. During all times material herein, plaintiff's books of account were kept on the accrual basis and its corporation income tax and declared value excess profits tax returns were filed on the same basis.

"V. On or about March 2, 1943, plaintiff filed its corporation income tax and declared value excess profits tax return for its fiscal year ended November 30, 1942.

"[Proceeds from Agricultural Marketing Erroneously Excluded from Cost of Goods Sold]

"VI. In filing its corporation income tax and declared value excess profits tax return for its fiscal year ending November 30, 1942, plaintiff excluded from its cost of goods sold the amount of $8,588.29, which amount represented the remaining proceeds from agricultural marketing done for its patrons during the fiscal year ending November 30, 1942. Such remaining proceeds were charged against the gross receipts of plaintiff for the fiscal year ending November 30, 1942, the individual accounts of the patrons credited therefor, and capital certificates for such amounts were duly issued to such patrons.

"VII. The aforesaid sum of $8,588.29 was erroneously excluded by plaintiff from its cost of goods sold for said year and, as a result, plaintiff overpaid its corporation income and declared value excess profits taxes for such year in the amount of $2,541.59.

"VIII. On or about March 1, 1943, plaintiff paid to the them Collector of Internal Revenue of the United States for the District of Oregon the sum of $590.23, on or about March 2, 1943, the sum of $2,048.56, and on or about April 21, 1943, the sum of $120.61, making a total payment of $2,759.40, being the full amount of corporation income tax and declared value excess profits tax shown as due on its said tax return for the fiscal year ending November 30, 1942. Within the time required by law and on or about February 14, 1946, plaintiff filed with the Collector of Internal Revenue of the United States for the District of Oregon, for transmission to the Commissioner of Internal Revenue of the United States, its claim for refund based upon the fact that it had erroneously excluded from its cost of goods sold the amount which represented the remaining proceeds from agricultural marketing done for its patrons during the fiscal year ending November 30, 1942.

"IX. On October 21, 1946, the Commissioner of Internal Revenue mailed to the plaintiff a notice of disallowance in full of the aforesaid claim for refund under the provisions of Section 3772 (a) (2) of the Internal Revenue Code.

"From the foregoing Findings of Fact, the Court draws the following

"Conclusions of Law

"I. By the provisions of plaintiff's Articles of Incorporation, which were in effect during its fiscal year ending November 30, 1942, plaintiff was required to return to its patrons in proportion to their patronage all remaining proceeds from agricultural products marketed for them, after payment of advances made by plaintiff to such patrons, plaintiff's expenses, and legal interest to its stockholders on the amount of their capital stock.

"II. Plaintiff erroneously excluded from its cost of goods sold the sum of $8,588.29, representing the remaining proceeds from agricultural marketing done for its patrons during the fiscal year ending November 30, 1942.

"[Proceeds Not Income to Taxpayer]

"III. The aforesaid remaining proceeds from agricultural marketing done for plaintiff's patrons during the fiscal year ending

November 30, 1942, in the amount of $8,588.29, belonged to such patrons, never became the property of plaintiff, and were not income to it.

"IV. By reason of the foregoing, plaintiff is entitled to recover judgment against defendant for the sum of $2,541.59, together with interest thereon as provided by law, and for its allowable costs and disbursements incurred herein.

(R. D. Burchard)

This case illustrates the need for better cooperative terminology. In a technical sense a marketing cooperative should not have an account entitled "cost of goods sold." Instead, the title should be "payments (or advances) to producers for products marketed," "payments (or advances) to members for products received," or some such appropriate designation.

Although the court in this instance took no exception to the defective term and readily understood that the amounts involved actually were returns on sales proceeds, it is considered undesirable for cooperatives generally to adopt ordinary commercial nomenclature in those situations were the latter fails to clearly bring out the distinctive features of cooperative operation.

(George J. Waas)

ADDITIONAL PAYMENT TO PATRONS DURING PART OF FISCAL YEAR, BASED ON INVENTORY GAIN WHEN O.P.A. PRICE CEILING WAS REMOVED, VIOLATED NO VESTED RIGHTS OF NONPARTICIPATING STOCKHOLDER-PATRON

An unreported decision by a Minnesota District Court (Fourteenth Judical District) for the County of Norman, in Dewey E. Viker v. Halstad Elevator Company, Inc., contains interesting dicta on the subject.

In this case, plaintiff, a stockholder-patron of the defendant cooperative marketing and purchasing corporation, brought suit for a declaratory judgement. The action, by stipulation, was later changed to one for an accounting. The sole question was whether the method followed by the defendant in distributing its net proceeds for the fiscal year 1946-47, as determinded by the board of directors and ratified by its stockholders, had violated any vested rights of the plaintiff as a stockholder and patron of the defendant during that fiscal year. Although Judge Lundgren decided the case on the narrow ground that plaintiff's acceptance and cashing of his patronage dividend check constituted an accord and satisfaction, he nevertheless filed extensive findings of fact and a memorandum opinion on the merits of the situation presented by these facts. Excerpts from the findings of fact follow:

> "1. That the defendant Halstad Elevator Company is a corporation, duly organized on April 15, 1919, under and pursuant to Sections 6479 to 6489, both inclusive, of Chapter 58 of the General Statutes of Minnesota for the year 1913; that on July 19, 1938, the defendant corporation elected to come under the provisions of Chapter 326, Session Laws of the State of Minnesota for the year 1923; that appropriate articles and by-laws have been adopted by said corporation and that the defendant's corporate existence is now governed by Sections 308.05 to 308.18 and Section 308.42 of Chapter 308, Minnesota Statutes Annotated; that as such, the defendant corporation was authorized to engage in cooperative marketing and purchasing activities, including the marketing of flax on the cooperative plan, and was by statue, its articles of incorporation and its by-laws required to distribute its net earnings, in excess of dividends on capital stock and additions to its reserve and surplus funds, to its patrons at least once annually on the basis of patronage for that year.

"2. That since its incorporation the defendant has engaged in the business of cooperative marketing and purchasing of grains and seeds and other commodities on the cooperative plan; that at all times herein material the management of its affairs has been vested in a board of ten directors who were empowered to make all necessary rules and regulations not inconsistent with law or the by-laws of the corporation; that periodic distribution of the net income of the defendant's operations have been made pursuant to resolutions adopted by its board of directors; that reports thereof have been made to the stockholders of the defendant corporation at its annual meetings and that the method thus adopted by the board has been approved by the defendant's stockholders; that, whereas, the term 'on the basis of patronage' is not defined with particularity in either the statute, articles, or the by-laws of the defendant corporation, the board of directors has in pursuance of its power to make rules and regulations for the government of the financial affairs of its operations adopted a practical construction of the term 'on the basis of patronage' to mean that the net margins should be computed and paid for so far as possible and practicable to do so in such manner as will return to each patron substantially the net margins which resulted from his patronage, thereby treating the payment thus made to a patron as an intermediate or final patronage payment to the patron for the commodity thus cooperatively handled by the corporation in behalf of such patron; thatto that end the board of directors has caused to be set up separate books for its grain department and oil department, and separately computed and distributed the net margins in each of those departments; that within each department the net margins of each particular major commodity were computed for a determination of the amount which the net margins on such commodity contributed toward the total net income of such department, thus recognizing the principle that the net margins should be returned to the patrons whose patronage produced them; that from 1939 to 1946 the net margins and final patronage payments were calculated and paid separately for wheat, barley, flax, oats, coal and twine within the grain department and as far back as 1932 the net margins on gasoline, kerosene, grease, oil and distillate have been separately computed and paid."

The court then found that plaintiff was a patron and stockholder of defendant, that he marketed 2,106 bushels and 6 pounds of flax on October 31, 1946, for which he received an initial payment of $7.00 per bushel, and that he marketed 34 bushels and 16 pounds on May 26, 1947, at $5.70 per bushel.

"4. That prior to 1946 it was the practice of the defendant in its flax marketing operations to make initial payments to its patrons at twenty-five cents to twenty-six cents below the Minneapolis price; that this differential included a total of twenty-one cents for freight, weighing fees, inspection fees and commissions, giving to the defendant a gross margin of four to five cents for the operation of defendant's elevator and final patronage payments, if any; that it was also the practice of the defendant to promptly hedge its grain purchases, thereby avoiding inventory losses from price declines and also the possibility of inventory gains from price increases; that by reason of these practices the twenty-five cent to twenty-six cent margin necessarily remained quite uniform as the initial payments which it made to its customers fluctuated with the fluctuations in the Minneapolis price.

"5. That during the defendant's fiscal year here involved, up to October 16, 1946, the price of flax was determined by ceilings established by the Office of Price Administration; that during said time there was an increasing demand for flax and in the summer of 1946, for the first time in history, Minneapolis buyers began buying flax on 'to arrive' contracts, with one way escalator clauses which provided that if the Minneapolis price of flax should decline between the date of the contract and date of delivery, the buyer nevertheless would pay the price specified on the date of the contract, but if the price increased in that interval of time, the buyer would pay the increased market price on the day of delivery in Minneapolis; that consistent with its business practices the defendant's flax transactions were handled on the 'to arrive' basis during the life of said contracts for the benefit of its flax patrons; that the O.P.A. ceiling prices applicable to defendant's purchases of flax at Halstad, Minnesota, were \$3.15 per bushel in June, 1946, and \$3.60 in July 1946, and \$3.80 in August, September and up to October 16, 1946; that on October 16, 1946, the O.P.A. ceiling price was removed; that from June 1, 1946, to October 25, 1946, the individual patrons of defendant corporation sold and delivered to defendant at Halstad, Minnesota, a total of 4712.43 bushels of flax to be cooperatively marketed by it for them; that during the month of June, 1946, the defendant purchased from its patrons 863 bushels of flax to be cooperatively marketed by it for them, and paid therefore initial payments computed at the rate of \$3.15 per bushel; that during the month of July, 1946, the defendant purchased 76 bushels of flax from its patrons to be cooperatively marketed by it for them and paid

therefor an initial payment computed at the rate of $3.60 per bushel; that between August 1, 1946, and October 16, 1946, the defendant purchased 3742 bushels of flax from its patrons to be marketed coopertively by it for them and paid therefor initial payments computed at the rate of $3.80 per bushel; that between October 17, 1946, and October 25, 1946, the defendant neither brought nor sold any flax; that on October 16, 1946, the defendant had on hand 3823 bushels of flax; that between October 17 and October 25, 1946, the price of flax rose from $3.80 per bushel to $6.70 per bushel, and that thereby the defendant realized an inventory gain of $11,086.70 which was subsequently increased through the sale of flax at $7.25 per bushel at Minneapolis; that the plaintiff sold and delivered no flax to the defendant between June 1, 1946, and October 16, 1946.

"6. That at a meeting of the board of directors of the defendant corporation held at the defendant's office in Halstad, Minnesota, on Thursday, May 8, 1947, the directors of said defendant corporation, being informed of the gross margins which it had realized upon its flax inventory after the removal of the O.P.A. ceiling prices and being cognizant of the income tax exemption afforded it as a cooperative, did by resolution declare 'that any surplus, earnings, savings, or by whatever name designated on the association's balance sheet or annual statement, belongs to the patrons of this association, and is to be allocated to each patron based on patronage, as shown by the records of the association;' that a motion was made and carried 'That the conditions of out present years business in flax, be taken up with the legal department of the Farmer's Elevator Association, and be recommended if possible that an equalization payment be made to members who sold flax before O.P.A. regulations went out of effets;' that thereafter, acting upon the information contained in a letter which received from the Farmer's Elevator Association of Minnesota, the board of directors determined that each patron who delivered flax to the defendant between July 1, 1946, and October 25, 1946, should receive a payment in the nature of an equalization payment equal to the difference between the initial payment received by such patron at the time of the sale and delivery of said flax and the sum of $6.00 per bushel; that pursuant to said motion the defendant did on the 15th day of May, 1947, issue and deliver to its patrons who had delivered flax to it to be cooperatively marketed between the 1st day of June, 1946, and the 25th day of October, 1946, computed upon the flax so delivered by such patrons in accordance with the board's motion, in the total aggregate amount of $10,874.35, which said sum was charged upon the defendant's books to its ledger account entitled, 'Purchases - Initial Payments;' that at the time of the making of said motion

by the defendant's board of directors the defendant's fiscal year had not closed, nor had its books been audited; that in not them knowing the exact requirements of its various funds the formula thus adopted represented an approximation which would substantially return to each flax patron the proportionate share of the net margin which the defendant would realize upon such patron's flax transaction; that in so doing the board of directors acted within their scope of authority, in good faith, and in accordance with the policy of patronage payments which through usage had been established by its stockholders."

The court then found that at the close of the fiscal year on June 1, 1947, the defendant took proper action to establish patronage refunds by departments, and on separate products handled, as it had in the past; that these were duly computed and paid, one-half in cash and one-half by "Equity Reserve Credit"; that plaintiff was issued a check for $1,366.00 which stated on its face "This check covers one-half of your '47 patronage divident and balance of equity reserve due you for 1942 and 1943"; and that he accepted, endorsed, and cashed this check.

The judge commented on the merits of plaintiff's claim, in part, as follows:

"In arriving at my conclusion I have, in the interpretation of the statutes here involved, studied the historical background of cooperatives generally in an effort to determine the fundamental characteristics of its corporate existence. While the defendant has engaged both in the business of buying products raised by its producer members and patrons and also in the business of selling cooperatively commodities needed by its members and patrons, the issues here involve the grain department of the defendant's business, and therefore the defendant for the purposes of this decision can be considered merely as a marketing agency.

"I believe that the record is clear that historically cooperative marketing agencies came into being for the mutual benefit of its members and patrons in procuring a higher price for the products produced by them. Higher price for the products produced is therefore its main objective and must be borne in mind in the interpretation of the statutory provisions under which cooperatives are now governed.

"When a patron, therefore, as in the instances here under consideration, sold and delivered flax to the defendant corporation there arose not only the contractual relationship of vendor and

vendee but also, to a limited extent at least, the relationship of principal and agent; for in cooperatively marketing the flax thus purchased the defendant became the agent of its several patrons in the attainment of its primary objective, namely, 'a higher price.' The statute has specifically sought to protect the rights of the producer by providing that the net earnings, in excess of dividends on capital stock and additions to reserve and surplus, shall be distributed on the basis of patronage annually or oftener. Such distribution, therfore, in the light of the primary objective of a cooperative marketing agency, while referred to as a patronage dividend, can in reality have but one meaning, namely, an additional payment to the initial price paid at the time of delivery which, when taken together, forms the total price which such patron receives for his product.

"In the determination of such additional payment the board of directors stands in the position of trustees between its members and patrons and the defendant as a corporate entity. Since the corporation is organized for the mutual benefit of its members and patrons in the attainment of its primary objective and not for profit, it logically follows that the distribution should be made as nearly as practicably possible consistent with proper business management to those patrons whose products produced the income.

"So long as the price of flax was governed by the law of supply and demand no serious difficulty arose in the distribution of the defendant's net earnings, for by maintaining a uniform spread of twenty-five to twenty-six cents per bushel the initial payments which it paid its patrons rose and fell with the Minneapolis market. Any marketing earnings which the defendant realized under this method were uniformly contributed by each unit cooperatively marketed and therefore could be uniformly distributed at the end of the fiscal year. The difficulties which the board encountered here were the result of an attempt to establish a ceiling price by government fiat in disregard of the law of supply and demand. When the board availed itself of the provisions of a marketing contract which contained a one way escalator clause, it clearly did so for the benefit of the patrons who marketed their flax with it during the time that the governmental agency sat upon the ceiling lid. The distribution of its earnings, thus realized during that period, back to its patrons was therefore clearly within the law and in accord with the primary objective of its business as a marketing agency, I have therefore concluded that the distribution which the boardof directors of the defendant corporation made on May 15, 1947, was according to law, in harmony with the articles and by-laws of the defendant corporation, and within the rule making

powers of the board. The formula which it adopted does not concern the Court for that is a matter of business judgement of the board of directors and not within the jurisdiction of this court under the present action.

"If any error has been committed here, it was in the final distribution but of that the plaintiff cannot complain for this error did not result in damage to him as the formula which the board adopted was not contrary to law, nor the by-laws of the corporation, and as it was subsequently adopted by its stockholders the matter ends there so far as this action is concerned."

(R. J. Mischler)

Here again is an instance of poor cooperative terminology in that the association's articles and bylaws use the terms "net earnings" and "surplus funds." As to their normal transactions with patrons, cooperatives cannot be said to have "net earnings" or "net profits." A marketing cooperative doen have a "remainder of sales proceeds," or "net operating proceeds payable to patrons," etc. It should not have "surplus" or "surplus funds," but on the other hand may have "capital reserves."

In this case the enhancement of prices on inventory was clearly an operating matter and thus inured to the benefit of patrons, rather than of stockholders. There are other questions, however, never ruled upon by the courts to my knowledge, that are somewhat analogous and have been in the moot class, as for example, do the stockholders, as such, or the patrons, as such, have a right to the income derived by a cooperative from nonoperating sources, such as capital gain on property sold, receipts of interest, rentals, life insurance proceeds, etc.?

(George J. Waas)

ACCRUAL OF AMOUNTS REPRESENTED BY CREDIT MEMORANDA UNAFFECTED BY POSSIBILITY OF RENEGOTIATION

On March 16, 1951, the Circuit Court of Appeals for the Ninth Circuit affirmed the decision of the Tax Court (14 T.C. 158), heretofore referred to in Summary No. 45, page 21, in Harbor Plywood Corporation, a Corporation, Petitioner v. Commissioner of Internal Revenue, Respondent (187 F. 2d 734).

The issue and its disposition are stated as follows in the head note:

> "When gross income reported: Cooperative nonprofit association: Accrual of amounts represented by credit memorandums: Renegotiation as a contingency. -- The accrual basis taxpayer was a member stockholder of a cooperative nonprofit association organized as a corporation, and also on the accrual basis, During the taxable years involved the association issued credit memorandums to taxpayer representing his pro rata share of the excess of the associations income over its expenses for the year, and credited such amounts to taxpayer in its books. The credit memorandums also stated that the amounts therein would not be distributed until it had been settled whether they were subject to renegotiation as the Government was contending. On such facts the amounts represented by the credit memorandums accrued were taxable to the taxpayer in the years when he received the credit memorandums and not in the year or years when they were paid. The possibility of renegotiation did not represent such a contingency as would prevent accrual."

(R. D. Burchard)

A reading of the original case before the Tax Court (14 T.C. 158) does not reveal whether the recipient of the patronage distribution (Harbor Plywood Corporation) had the same fiscal year (namely March 31st) as the cooperative association (Pacific Forest Industries) making the distribution. I would assume that the two fiscal years were not coincident from the court's dicision that "the credit memoranda accrued were taxable to the taxpayer in the years when he received the credit memoranda and not in the year or years when they were paid."

Otherwise, in the case of two connected entities (such as an association and its member) I would have expected the court to rule that an accured cooperative distribution must be reported as constructively received on the tax return of the distributee in the same fiscal year in which it was set up as an accrual on the association's books.

(George J. Waas)

COOPERATIVE'S DISCOUNT SALES VIOLATE STATE FAIR TRADE ACT

In Sunbeam Corp. v. Civil Service Employees' Coop. Ass'n, 187 F. 2d 768, the United States Court of Appeals for the Third Circuit held that the granting of a discount at the time of sale to its customers by a cooperative was a violation of the Pennsylvania Fair Trade Act. The court did not have before it the applicability of the Act to patronage dividends. The question remains: "What would be the effect if the amount of the discount instead of being allowed at the time of sale were deferred and paid as a patronage dividend?"

(R. D. Burchard)

BREEDING ANIMALS AS CAPITAL ASSETS

In an article from the May 1951 issue of the American Bar Association Journal, transmitted by letter of May 24, 1951, to the members of its law committee, by the National Council of Farmer Cooperatives, the following favorable dicisions are cited with respect to the treatment, for income tax purposes, of the proceeds of the sale of breeding animals as proceeds from the sale of capital assets: Albright v. United States, 173 F. (2d) 339 (8th Cir., 1949); United States v. Bennett, 186 F. (2d) 407 (5th Cir., 1951); Fawn Lake Ranch Co., 12 T.C. 1139 (nonacquiescence by Commissioner). It is of course to be understood that the tax on the gain from the sale of a capital asset held for more than six months is more favorable to the taxpayer.

We call attention to two other decisions to the same effect: Mitchell v. United States (U.S. District Court for the Northern District of Califronia, Southern Division, February 8, 1951), 96 F. Supp. 473; Davis v. United States (U. S. District Court for the Northern District of Iowa, Cedar Rapids Division, January 22, 1951), 96 F. Supp. 785.

(R. D. Burchard)

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